ECONOMICS

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The role of advertising in the conditions of monopolistic competition: theoretical foundations

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Abstract. This article explores the changing views on the role of advertising as a factor in the impact of competition in the industry. Separately characterized approaches to definition of advertising as a source of information and as a factor of market power. The essences of anti-competitive and pro-competitive theories of advertising are determined.

Keywords*: advertising, competition, information, market power, consumer behavior*

Advertising review in terms of economic theory is necessary due to the general requirements of the knowledge of the mechanism of action of economic laws of market functioning and practical needs of society. A large number of external factors influences decisions of consumers to purchase goods. Consumers can choose products basing on their own experience, the experience of relatives and friends, in conversations with sellers and other experts, on the existing data on prices and on product features information, appearing on various publicly available sources. However, advertising leads to decisions of producers to expand product sales, increase market share. As a result, advertising provides a direct or indirect impact on the market environment and the state of competition in the industry.

It is hard to overestimate place of advertising in modern economic relations. Advertising allows consumers to get valuable information on product diversity and market prices of specific goods and services. Also advertising enables manufacturers and retailers to expand product distribution channels to influence consumer preferences and therefore the market demand more effectively implement competitive strategies. Advertising as an effective method of influence on consumer preferences, aims to increase demand for products corresponding brand, improve the company's reputation, increase the image, respectively, and attract new customers for new products, including luring customers from competitors. Thus, it is clear that advertising is effective in differentiated product markets.

It is certainly important to generalize the approach to determine the effect of advertising on the competitive environment sectors, such as its components: the amount of consumer demand and its elasticity; consumer tastes, their welfare; pricing; barriers to entry into the industry of new producers; conditions of formation of market power.

Some authors have suggested that advertising creates market power by differentiating brands and lowering price elasticity. Others have viewed advertising as an efficient source of information about the existence of substitutes, arguing that advertising increases price elasticity.

There are several essential reasons why advertising has been of interest to economists. Advertising has been debated at length in the theoretical economic literature as it is closely tied to the issues of information and search, topics that have taken a prominent place in economic theory in recent decades. Advertising also features in models of entry barriers and product quality. Throughout its long debates advertising has remained a controversial topic.

In economic theory, this problem was first were investigated in the works of E.Chamberlin and J.Robinson. Further research of advertising as a tool for enhancing market power was made in the works of N. Kaldor, J. Bain, G. Grossman and C. Shapiro, A. Dixit and V. Norman, J. Lambin, R. Schmalensee and other scientists. The question of whether the amount of advertising provided by vendors for this optimal market structure over the years increasingly attracted the attention of scientists. Important investigations, which began these studies include work by L. Tesler, G. Butters, G. Grossman and C. Shapiro, A. Dixit and B. Norman, K. Bagwell, S. Anderson.

An early reflection is offered by Marshall. He distinguishes between two roles that advertising may play. Advertising has a constructive role when it provides information to consumers, so that they may satisfy their wants at lower cost. But advertising also may play a socially wasteful combative role, by offering little information and serving only to redistribute consumers from one firm to another [5].

Chamberlin, in his theory of monopolistic competition, models a firm’s advertising expenditures as a “selling cost” that shifts out the downward-sloping demand for the firm’s differentiated product. He accepts that advertising may provide information to consumers, and he allows, too, that advertising may be persuasive [5]. Informative advertising better enables consumers to respond to price differences and thus increases the elasticity of demand, but persuasive advertising creates brand loyalty and thereby reduces the elasticity of demand [3].

Some authors have suggested that advertising creates market power by artificially differentiating brands and thereby lowering price elasticity. Others have viewed advertising as an efficient source of information about the existence of substitutes, arguing that advertising increases price elasticity [10]. This idea has been formalized in models closely linked to the large literature on consumer search, but rather than consumers searching for products, firms search for consumers via advertising. Here advertising provides useful information to consumers such as the existence, the quality, or the price of a good

As mentions Mitra A., there are two divergent theoretical viewpoints about the economic effects of advertising. In the first one, advertising is viewed as a means of persuasion and is postulated to lead to increased product differentiation that decreases perceived substitutability among competing alternatives. Thus, according to this school of thought, advertising reduces the price elasticity of demand. The other approach, based on the economics of information theory developed assumes that price elasticity is a function of consumer awareness and of qualitative knowledge about close

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brand substitutes. The basic idea of this point of view is that advertising provides information about alternatives and, therefore, increases price elasticity [10]. Butters defines these two views as "advertising as a set of psychological ploys which induce consumers to buy products or brands that they otherwise would not buy", or as "a provision of information which allows consumers to make more discriminating choices within the framework of fixed set of preferences [6]. The persuasive view of advertising typically sees changes in preferences in the form of an outward shift of demand, a decrease of elasticity of substitution between products, or increased monopoly power forms, and thus increasing market prices, while the informative view sees increased information for consumers, stronger competition and thus lower market prices. N. Kaldor asserts a harmful effect of advertising and suggests the introduction of a tax on advertising [9].

Research in economics and marketing has not produced any conclusive evidence on this controversial issue. Some scholars have found support for the view that advertising decreases price elasticity of demand. Other studies that have examined price levels or measured price sensitivity directly or through price-advertising interactions have found a positive relationship between advertising and price elasticity, which is consistent with the information view. These studies are often not comparable in terms of their focus. Some studies examine the effects of advertising by an individual firm and measure price elasticity at the brand level, whereas other studies examine the effects of industry advertising and measure price elasticity for the product category. Because the effects of advertising by an individual firm are expected to differ from the effects of advertising by the industry, it is not surprising that some of these studies report increases in price elasticity while others show the opposite.

Beyond providing information on the existence of substitutes, advertising provides recall cues and, thereby, increases the number of effective substitutes considered at the time of choice. Price elasticity is a function of perceived substitutability; therefore advertising can increase price elasticity by increasing the number of brands considered. This study demonstrates that for product markets in which consumers have to rely on memory to generate alternatives, the effects of increased advertising by brands may be to increase price elasticity, contrary to the predictions of the market power school. Thus, if the direct recall-based effect of advertising on consideration set size is sufficiently strong, even differentiating advertising could have a positive effect on price elasticity [10].

The idea that advertising might serve as a transporter of information, has been formalized in models closely linked to the large literature on consumer search, but rather than consumers searching for products, firms search for consumers via advertising. Advertising provides useful information to consumers such as the existence, the quality, or the price of a good. In these models advertising expenditure has a marginal effect on a firm's demand that will correspond to the marginal advertising cost it faces. Therefore changes of the cost function will likely change advertising expenditure, and thus demand. More advertising increases competition and thus lowers prices. Rauch investigated, that both effects, the informative and the persuasive effect of advertising, are present in some industries to a varying degree. This variation may help to distinguish different working mechanisms of advertising. In the literature there is a class of models of advertising based on the view that advertising expenditure itself may serve as a quality signal. This idea was developed by Nelson and later formalized [11].

The information models of informative advertising typically predict that advertising expenditure decreases with the marginal cost of advertising. However, since they only consider the informative aspect of advertising, they predict that advertising lowers consumer prices. Thus the models cannot predict the finding that advertising increases in some industries with low information content in advertising. In these models, a subsidy for advertising would increase welfare.

Informative forces, which decrease prices with advertising, dominate in the industries of food and education; while persuasive forces that increase consumer prices with advertising seem to dominate in the industries of alcohol and tobacco, transportation, hotels and restaurants.

In the analysis of Grossman and Shapiro, product is differentiated and advertising also provides information about the properties of the product. Scientists said that the role of advertising in markets of differentiated product cannot be overstated. Advertising companies are both channels of providing consumers with product information and means to improve loyalty to brand. In contrast, A. Diksit and V. Norman believe that advertising has only the function of belief: it just changes the behavior and has no effect on welfare or efficiency of resource allocation.

Nelson considers uninformative advertising that is neither informative nor convincing. In terms of product diversification has a positive externality trademarks, advertising a product of the firm contributes to sales of other products. For advertising costs are a signal of quality, they must be so large that the company could not cover them with current revenues for a short time, and the customer must be informed about it. Nelson argues that such advertising can increase efficiency, giving consumers the signals relative to the quality of goods [2].

Persuasive advertising has a significant impact on public welfare. According A. Herasymenko, there are two main mechanisms of its effects. The first is to build commitment to consumer brand as a prerequisite for full or partial monopolization of the market. Market power generated so allows us to reduce the volume of production compared to competitive, causing loss of social well-being of the first type. The second mechanism involves the advertiser socially inefficient investment in persuasive advertising that does not create real value, and vice versa - diverts limited economic resources to apply them to sustain demand for goods at competitive level subject to the monopoly price increase, thus creating social cost of the second type . And in fact, and otherwise making sure advertising reduces welfare, and therefore so is the use of which should be limited if we are to increase the efficiency of the national economy [1, p. 151].

On the other hand, advertising costs are part of cost irreversible entry that discourages penetration of new competitors into the market. Model of Dorfman-Steiner shows the dependence of the optimal volume of advertising expenditure on the characteristics of the residual demand for goods firm. The optimum of advertising costs in the total revenue of the firm is determined by the ability of the firm to influence the price of its product, on the one hand, and the elasticity of demand for advertising on the other hand [2].

The direct relationship between the intensity of persuasive of advertising firm and its market power is formalized in Dorfman-Steiner model, which implies that the positive profitability of the company as a result of strong advertising brand, which entails more intensive advertising [1, p. 149].

R. Dorfman and P. Steiner suggest that the source of intensive advertising investment in information asymmetry in the market is not only and not so much a desire to protect its market power by potential competition as usual desire to maximize profits [2, p. 150].

A lot of literature is devoted to the possible impact of advertising on entry conditions of a company in this industry. The most important source of entry barriers are advantages entrenched brands that are expressed in terms of product differentiation. These benefits are the result of long-term impact of advertising on consumer behavior. Advertising, according to J.Bain, is the main source of goods differentiation advantages. Most of his observations point to the importance of uncertainty about the quality of the product. However, the mere fact that investment in advertising provides long-term effect, hardly a greater extent indicates the entry barriers than the long-term nature of investments in companies and equipment [2, p. 23].

Thus, we see multidirectional impact of advertising on mechanisms of the competitive environment industry. Its effect is ambiguous, has positive and negative effects on various subjects.

At the same time, advertising is a subtle and difficult subject, with important effects that remain poorly understood. Economists now have tree views on advertising. The persuasive view holds that advertising primarily affects demand by changing tastes and creating brand loyalty. The advertised product thus faces a less elastic demand. This elasticity effect suggests that advertising causes higher prices, though this influence may be moderated by the presence of production scale economies.

The informative view holds that advertising primarily affects demand by conveying information. The advertised product thus faces a more elastic demand. This elasticity effect suggests that advertising causes lower prices, an influence which is reinforced when production scale economies are present. The informative view suggests further that advertised products are generally of high quality, so that even seemingly uninformative advertising may provide the indirect information that the quality of the advertised product is high.

The complementary view holds that advertising primarily affects demand by exerting a complementary influence in the consumer's utility function with the consumption of the advertised product. As an example, it may be that a consumer values "social prestige" and advertising may then serve as an input that enables the consumer to derive more social prestige when the advertised product is consumed. The complementary view is logically distinct from the persuasive view, since the complementary view holds that consumers possess a stable set of preferences into which advertising enters as one argument. The complementary view is also logically distinct from the informative view, since under the complementary view advertising may affect consumer demand even if it contains no (direct or indirect) information. An important benefit of the complementary view is that the fixed-preferences assumption permits a straightforward welfare analysis of seemingly persuasive advertisements. Under this view, the market may provide too little advertising, since the advertising firm does not internalize the full increase in consumer surplus that its advertising engenders [5].

In general, the economic analysis of advertising took place in several stages. The analysis began with the general views that given a broad interpretation of the advertising. These views, however, were more qualified because they were subjected to empirical, theoretical and empirical assessment again. We now have a clearer understanding of key factors influencing the competitive advertising environment, and we are more confident about the consequences of ads in the functioning of competition in industries. Today, theoretical studies of advertisement have plenty of questions that do not have specific answers. To address these issues new efforts should be based on assumptions about the impact of advertising on consumer and empirically proven.

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Соболева М.В. Роль рекламы в условиях монополистической конкуренции: концептуальные подходы

Аннотация. В данной статье рассматриваются меняющиеся взгляды на роль рекламы как фактора влияния на конкуренцию в отрасли. Отдельно характеризуется подходы к определению рекламы в качестве источника информации и как фактора рыночной власти. Определяется сущность антиконкурентной и проконкурентной теорий рекламы.

***Ключевые слова**: реклама, конкуренция, информация, рыночная власть, поведение потребителя*